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OF THE STATE OF CALIFORNIA

Application of Pacific Gas and Electric Company Proposing Cost of Service and Rates for Gas Transmission and Storage Services for the Period 2015 – 2017 (U39G).	Application 13-12-012 (Filed December 19, 2013)
And Related Matter.	Investigation 14-06-016

SUPPLEMENTAL OPENING BRIEF OF THE INDICATED SHIPPERS ON ALLOCATION OF $850 MILLION SAN BRUNO PENALTY TO GAS TRANSMISSION AND STORAGE RATES

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Pursuant to Ordering Paragraph 63 (OP-63) of D.16-06-056 and the email ruling of Administrative Law Judge Dudney dated July 8, 2016, the Indicated Shippers[1] submit this Supplemental Opening Brief recommending a methodology for allocating the $850 million San Bruno Penalty adopted in D.15-04-024 (San Bruno Penalty or Penalty) to Gas Transmission and Storage (GT&S) rates.

I. EXECUTIVE SUMMARY

The Indicated Shippers recommend allocation of 100% of the San Bruno Penalty to offset operating expenses authorized by D.16-06-056 (Expense Method). Absent further mitigation, PG&E's noncore customers will face

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1 Member companies include Aera Energy LLC, Chevron U.S.A. Inc., Phillips 66 Company, Tesoro Refining & Marketing Company LLC and Shell Oil Products US.

unprecedented rate increases on August 1, 2016, with further increases through 2018:

- Industrial transmission customers will face a 94% end-use rate increase on August 1, rising to an increase of up to 115% by 2018.
- Electric generation (EG) transmission customers will face a 204% end-use rate increase on August 1, rising to an increase of up to 249% by 2018.
- Backbone transmission rates will also materially increase on August 1, with increases ranging from 38% for the Baja Path and 44% for the Redwood Path.

The magnitude of this rate shock calls for Commission action to maximize the immediate rate relief from the San Bruno Penalty by adopting the Expense Method.

Applying the Expense Method, rather than the 81% capital/19% expense method adopted in D.15-04-024 (Hybrid Method), has two unintended consequences that must be considered. First, because D.16-06-056 directed PG&E to apply the San Bruno Penalty before calculating the undercollection during the first five months of 2015, the Expense Method entirely eliminates the Ex Parte Delay disallowance adopted in D.14-11-041. Instead, the Commission should direct PG&E to apply the Ex Parte Delay disallowance *before* the San Bruno Penalty to maximize the benefits of the Expense Method. Second, the Expense Method adds $157 million to the return PG&E would earn under the Hybrid Method. The Commission should mitigate this effect to produce an Expense Method return that equals the Hybrid Method return.

Finally, tax treatment may have inadvertently reduced the potential ratepayer benefits of the San Bruno Penalty by $314 million. Ratepayers would benefit from a review of the Commission's recommendations on tax treatment of the Penalty following a final decision in this GT&S proceeding.

II. THE COMMISSION SHOULD APPLY 100% OF THE SAN BRUNO PENALTY TO RATE CASE PERIOD OPERATING EXPENSES.

PG&E's response to the Indicated Shippers' Data Request No. 26 provides additional insight into the benefits of the Expense Method relative to an 81% capital/19% expense allocation (Hybrid Method).[2] PG&E's response shows:

- The Expense Method reduces 2017 transmission level industrial end-use rates, compared with the August 1, 2016 rates, by $0.25/Dth (16%); in contrast, the Hybrid Method reduces the rate by $0.06/Dth (3.8%);
- The Expense Method reduces 2017 transmission level EG end-use rates, compared with the August 1, 2016 rates, by 22% ($0.25/Dth); in contrast, the Hybrid Method reduces the rate by 9.6% ($0.11/Dth);
- Although 2018 transmission level industrial and EG end-use rates increase more under the Expense Method than under the Hybrid Method, they remain $0.127/Dth lower in absolute terms;
- Differences between backbone transmission rates under the two alternatives are negligible.

The Indicated Shippers emphasize that the reduction achieved using the Expense Method, despite the unintended consequences discussed in Section III, are very material to their operations.

In theory, allocating more of the penalty to capital might yield a greater net present value (NPV), but nothing in the record illuminates the long-term benefits. First, it is possible the benefit of the Hybrid Method may be reduced as a result of income tax treatment of certain expenses. Second, the reduction benefits –

[2] Exhibit A presents a comparison of the rates provided by PG&E in response to Indicated Shippers' Data Request 26 for three scenarios: (1) D.06-06-056, (2) the Hybrid Method and (3) the Expense Method.

reduced depreciation expense, taxes and return -- would be realized over asset lives of up to 60 years. Given the extended period required to recapture the Penalty value, long-term, annual impacts of the Hybrid Method may be limited. Third, long-term benefits of this approach would accrue to future ratepayers who did not experience the substantial rate increases resulting from this GT&S.

The Hybrid Method is superior to the Expense Method in calculating the Ex Parte Delay disallowance. Under the Hybrid approach, a $75 million Ex Parte Delay disallowance is applied; under the Expense approach, the disallowance is zero.[3] It is not necessary, however, to adopt the Hybrid approach to retain the ratepayer benefit and deterrent value of the Ex Parte Delay disallowance. That benefit could be more simply retained by adopting the Expense Method and applying the Delay disallowance *before* the San Bruno Penalty, as discussed in Section III.A.

III. THE COMMISSION SHOULD MITIGATE THE UNINTENDED CONSEQUENCES UNDER THE EXPENSE METHOD.

The Expense Method produces two unintended consequences, relative to the Hybrid method, that confer a windfall on PG&E. The Commission should modify PG&E's revenue requirement to offset those impacts.

A. The Commission Should Mitigate the Impact of the Expense Method on the Ex Parte Delay Penalty.

D.16-06-056 requires the application of the San Bruno Penalty to revenues prior to calculating the Ex Parte Delay disallowance.[4] While the

3 PG&E Response to Indicated Shippers' Data Request 27, attached as Exhibit B.

4 D.16-06-056 at 404-05.

Indicated Shippers will not repeat the arguments from their opening brief,[5] the Commission should reconsider its decision and sequence the calculation of the Ex Parte Delay disallowance before the San Bruno Penalty.

B. The Commission Should Mitigate the Return Windfall Resulting from the Expense Method.

Application of the Expense Method instead of the Hybrid Method produces a return windfall for PG&E. PG&E's Results of Operation model, provided in response to Indicated Shippers Data Request 26, shows a return that is $157 million greater over the 2015-18 rate period under the Expense Method than under the Hybrid Method. The Hybrid Method provides a return to shareholders of $971 million.[6] The Expense Method provides a $1.13 billion return over the rate period,[7] which is roughly the same return resulting from D.16-06-056 before application of the San Bruno Penalty.[8]

Without more time to understand the RO model runs provided by PG&E, it is difficult to determine the interactions that produce the differences in the return produced by the two methods. Regardless of those interactions, PG&E shareholders should not be permitted to profit simply because the Commission chooses the Expense Method, rather than the Hybrid Method, to mitigate the

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5 Opening Brief of the Indicated Shippers on Allocation of $850 Million San Bruno Penalty to Gas Transmission and Storage Rates, July 7, 2016, at 8-9.

6 PG&E Response to Indicated Shippers Data Request 26, Results of Operations at Proposed Rates, Phase I –Adopted Plus 850M (81% Cap, 19% Exp), $\sum$ Row 31 (attached as Exhibit C to this Supplemental Opening Brief).

7 PG&E Response to Indicated Shippers Data Request 26, Results of Operations at Proposed Rates, Phase I –Adopted Plus 850M (100% Exp), $\sum$ Row 31 (attached as Exhibit D to this Supplemental Opening Brief).

8 PG&E Response to Indicated Shippers Data Request 26, Results of Operations at Proposed Rates, Phase I –Adopted, $\sum$ Row 31 (attached as Exhibit E to this Supplemental Opening Brief).

extreme rate shock from this GT&S proceeding. The Commission should adopt an incremental ratemaking disallowance to mitigate this unintended and undesirable shareholder windfall under the Expense Method.

IV. THE COMMISSION SHOULD RECONSIDER THE TAX TREATMENT OF THE SAN BRUNO PENALTY.

The ratepayer benefit of the San Bruno Penalty, regardless of the ultimate allocation methodology, may have been materially reduced by the tax treatment adopted by the Commission following the issuance of D.15-04-024. Acknowledging uncertainty surrounding tax implications of the San Bruno penalties adopted in D.11-04-041, the Commission urged taxing authorities to prohibit PG&E from deducting any San Bruno penalties for the purposes of calculating tax liability. The effect of this proposal on ratepayers, however, has not yet been explored, and this treatment may forfeit incremental ratepayer benefits of up to $314 million. Following the issuance of the decision on the San Bruno Penalty allocation, the Commission should review the Penalty's tax treatment to determine whether further ratepayer benefits could be gained under alternative treatment.

The potential tax effects of the Penalty on PG&E shareholders are unclear. Overland Consulting stated in its *Financial Analysis of PG&E Corporation* in August 2012:

> *Based on the information received in discovery and review of the Internal Revenue Code, it is not entirely clear whether these disallowances would be deemed "penalties" by the IRS for purposes of tax deduction. However, the CPUC should remain cognizant of the possibility that cost*

> *disallowances may have more favorable tax treatment for the company than fines.*[9]

The Commission reiterated this uncertainty in an April 2015 letter to the Internal Revenue Service and the California Franchise Tax Board (Tax Letter). The letter stated:

> *The matter of the tax consequences of such an important equitable remedy was not litigated in our proceedings. One consideration that prevented the CPUC from litigating this matter was the uncertainty as to how the IRS/BOE/FTB would dispose of an attempt to deduct the costs of complying with an order of equitable remedies.*[10]

This uncertainty appears not to have been resolved to date.

Parties briefed tax effects in I.12-01-007, with certain parties suggesting that the Commission consider these effects in determining the amount of the penalties for the San Bruno tragedy. Decision 15-04-024 concluded, however, that *"[t]here should be no adjustment to the bill credit or other remedies adopted in this decision to account for any tax benefits PG&E should receive*."[11] Shortly following the decision, the Commission sent the Tax Letter, stating: "*We also want to express our hope that any attempt by PG&E to deduct any of these costs will be disallowed on the basis of their punitive nature*."[12]

The Commission's clear goal in taking this approach was to prevent PG&E shareholders from profiting from the penalty. If the utility's revenues from ratepayers were reduced by the penalty amount, but PG&E were allowed to

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[9] Financial Analysis of PG&E Corporation, submitted by Overland Consulting on August 12, 2012, at 14.

[10] April 30, 2015, letter from the Commission to the IRS and FTB, attached as Exhibit F.

[11] D.15-04-024, Conclusion of Law 48, at 238.

[12] Tax Letter at 1.

deduct the expenditures it made using the penalties, its income tax burden would be lower than it would have been had no penalty been applied. The Office of Ratepayer Advocates suggested that the tax benefit would be 37% of the penalty amount.[13] If that occurred, the actual penalty experienced by PG&E would have been lower than the penalty's face value.

It is not clear what effect the proposed treatment would have on ratepayers in this proceeding or whether there is an alternative that would penalize PG&E but benefit PG&E ratepayers. One perspective would hold that there was no alternative; had the tax authorities permitted PG&E to deduct the expenses that were offset by the penalties, the Commission could not have required PG&E to pass on the tax benefits to ratepayers. The Commission's decision in OII 24[14] arguably would support this determination, concluding generally that tax benefits accruing to shareholders for expenses they fund will not be passed on to ratepayers.

Circumstances in this case, however, are unique and could lead to a different result. While the Commission intended the effect of the San Bruno Penalty to be punitive, it differs from a fine because penalty dollars will be spent on actual operating expenses or capital expenditures. The Penalty also differs from the disallowances addressed previously by the Commission. In OII 24, parties generally had in mind "disallowed" expenses that shareholders chose to make from the income they received, including "*expenses as donations, dues,*

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13 Rebuttal Brief of the Division of Ratepayer Advocates Regarding Fines and Remedies, June 7, 2013, at 7.

14 D.84-05-036, 15 CPUC 2d 42.

and contributions to charitable, social and political organizations, as well as expenses for legislative advocacy and certain types of advertising."[15] The Commission concluded that ratepayers should not get the benefit of tax reductions resulting from these expenditures:

> *It is the responsibility of the shareholders, through their utility management, to ensure that the utility operations are performed in a prudent and efficient manner, thereby generating the net income to provide a reasonable return on their investment. The net income is available for either distribution to the shareholders or capital reinvestment based on the policy of the board of directors. The choices of disbursement are at the directors' discretion. If they wish, for whatever reason, to make disbursements for donations, dues, or contributions to charitable, social, and political organizations, or to promote their corporate image through institutional or public relations advertising, the Commission should not reduce their earnings.*[16]

The Commission agreed with the parties that including these expenses in calculating the tax expense in rates would cause shareholders to "*suffer an unjustified loss of net income equal to the full amount of the disallowed tax deduction*" and give ratepayers "*an unjustified windfall arising from rates based on tax benefits that did not belong to them*."[17]

Different circumstances surround the San Bruno Penalty. The expenses that will be offset by the Penalty are not a product of PG&E's directors making choices on how to promote its corporate image; they are expenses incurred to address PG&E's past imprudence. Moreover, under these circumstances, *PG&E* would receive an "unjustified windfall" if it were permitted to keep the tax benefits

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[15] D.84-05-036, 15 CPUC 2d at 47-48.

[16] *Id.* at 49.

[17] *Id.* at 48.

of deducted expenses and *ratepayers* would suffer an "unjustified loss" of penalty value.

The Indicated Shippers do not suggest that the Commission analyze and decide this issue in the upcoming GT&S decision. The Commission should consider, however, whether alternative tax treatment may be available that would permit PG&E to deduct the Penalty expenses, yet allow the Commission to pass the resulting tax benefits on to ratepayers.

V. CONCLUSION

Noncore customers face an unprecedented doubling or even tripling of their transportation rates on August 1, with higher rates to come over the next two years. The Commission should maximize the remaining value of the disallowance to ratepayers by applying the Expense Method. Recognizing the likely unintended consequences of the Expense Method, the Commission should (a) modify D.16-06-056 to direct PG&E to apply the Delay disallowance against the 2015 undercollection before applying the Penalty and (b) direct a ratemaking disallowance to neutralize the additional return benefits to shareholders that would result from the Expense Method. Finally, following the issuance of its decision allocating the Penalty, the Commission should explore the tax treatment of the Penalty to determine whether an alternative approach is available that would benefit ratepayers. Regardless of the resolution of unintended consequences and tax treatment, the Indicated Shippers support adoption of the Expense Method.

Respectfully submitted,

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